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Principal and Surety—Miller Act—Duty to Apply Payments to a Secured Debt.—United States ex rel. Hyland Elec. Supply Co. v. Franchi Bros. Constr. Corp

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jurisdiction even though there is an arbitration clause in the contract, and section 10(a) in conjunction with other sections shows that the Board may find an unfair labor practice which requires an interpretation of the contract. Moreover, a decision that the Board did not have jurisdiction in this case would be adverse to the policy of avoiding delay. These were sufficient reasons for the court to hold that the Board had jurisdiction to find an unfair labor practice in *Huttig*.

THOMAS HOWARD BROWN

Principal and Surety—Miller Act—Duty to Apply Payments to a Secured Debt.—*United States ex rel. Hyland Elec. Supply Co. v. Franchi Bros. Constr. Corp.*[1]—Franchi Brothers Construction Corporation (Franchi) contracted with the United States to build an ammunition-storage facility at the Ethan Allen Air Force Base in Vermont. As required by the Miller Act,[2] Franchi furnished a payment bond under which Franchi would be liable for any nonpayment to persons supplying labor and materials for use on the government job. Maryland Casualty Company (Maryland) was surety on this bond. Fairway Electrical Contractors Incorporated (Fairway) subcontracted with Franchi to do the electrical work on the storage facility. Hyland Electrical Supply Company (Hyland) supplied Fairway with all the necessary electrical material which had a total value of $18,647.38. Hyland had previously supplied materials to Fairway for use on other jobs and still had accounts receivable for their payment.

Both Fairway and Hyland requested Franchi to make any progress payments from the government job in the form of checks payable to Fairway and Hyland as joint payees. Franchi complied with this request and sent several checks, which had a total value of $19,597, to Fairway, who forwarded them to Hyland for endorsement. Hyland endorsed the checks and returned them to Fairway. Fairway thereafter sent several payments to Hyland—in total $16,597—and instructed Hyland to credit only $9,000 to the account for materials supplied on the government job, directing that the remaining amount ($7,597) be applied to its other unsecured debts owed to Hyland. After each application of the payments, Hyland notified Franchi of the amount with which the Franchi-Fairway account was credited; Franchi made no reply. There was still a balance of $9,647.38 on the secured Franchi-Fairway account when Fairway became insolvent and filed a petition in bankruptcy. Hyland instituted suit in the United States District Court, seeking to recover the $9,647.38 against Franchi and the surety, Maryland. The district court entered judgment for Hyland against both Franchi and Maryland in the amount sought by Hyland.[3] The court reasoned that Franchi, because of its knowledge of Hyland's allocation of the funds, was estopped from asserting that Hyland had an equitable obligation to

[1] 378 F.2d 134 (2d Cir. 1967).

[2] 40 U.S.C. §§ 270a-270d (1964).

[3] United States ex rel. Hyland Elec. Supply Co. v. Franchi Bros. Constr. Corp., Civil No. 4061 (D. Vt., filed May 5, 1966).

apply the funds to the secured account. As the second ground for its decision, the court stated that the payments from Franchi were in the nature of reimbursements for labor as well as materials. The court reasoned that the portion of the payments for labor costs constituted "free funds" which Fairway could disburse as it pleased. The court apparently reasoned that the amount which Hyland applied to Fairway's other unsecured debts represented the payments by Franchi for Fairway's labor costs. The court did not distinguish Franchi's liability from Maryland's, but held that Maryland's liability as surety, depended on Franchi's liability and its subsequent failure to discharge and satisfy that liability.

Franchi and Maryland brought an appeal in the Court of Appeals for the Second Circuit. HELD: The judgment of the district court is modified by reduction in amount to $2,050.38, and as so modified, affirmed. Federal case precedent was cited as holding that a supplier has the equitable obligation to apply payments to the secured debt when he knows the origin of the payments. The majority found that Hyland knew Franchi to be the source of the payments by way of the joint-name checks, and thus reasoned that Hyland was under a duty to apply the funds to the secured account.

The majority opinion then treated Hyland's contention of equitable estoppel which was based on the fact that after each allocation of the funds, Hyland notified Franchi of the amount with which the Franchi-Fairway account was credited and Franchi never made any reply. In holding that this contention was groundless and of no effect on Hyland's duty, the majority cited Judge Learned Hand's statement in *Helvering v. Schine Chain Theatres Inc.*,[4] to the effect that there is no basis for claiming an estoppel unless there was detrimental reliance on the other party's actions.[5] The opinion pointed out that "[H]yland has not shown, indeed has not at any time alleged or claimed, that it relied to its detriment upon Franchi's silence or 'acquiescence' in any way. As for the unsecured debts, Hyland has made no claim or showing that any possible methods of collecting them, now foreclosed because of Fairway's insolvency, were passed up at the time by Hyland's reliance on Franchi's failure to object to the use of some of the storage facility funds for that purpose."[6] In its discussion of this issue of equitable estoppel, the majority, unlike the district court, distinguished the liability of Maryland, the surety, from that of Franchi, the principal. The majority held that Maryland could not in any event be liable on the bond because of Franchi's failure to respond to Hyland.

The majority next rejected the district court's "free funds" theory on the ground that the court's conclusions of law were not based on any supporting proof that Franchi's payments were for labor or other costs. A more basic ground for rejection was that the theory was based on an erroneous view of the law. There were no such "free funds" because the obligation of

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4 121 F.2d 948 (2d Cir. 1941).

5 "[T]here was no basis for an 'estoppel,' however broadly one uses that disastrous word. This is true because, however nebulous, it has always had at least this solid centre; that the party who invokes it shall have acted to his detriment in reliance upon what the other party has done." Id. at 950.

6 378 F.2d at 138.

the subcontractor (Fairway) and the supplier (Hyland) to apply the payments to the secured debt extended to all the payments and did not require payments to be specifically earmarked for the secured debt.[7]

The majority concluded that Hyland was bound by the duty to apply the payments to the secured Franchi-Fairway account, but only to that portion of the funds which it actually received into its control. Thus, since Hyland received $16,597, Franchi and Maryland were relieved of any obligation with respect to that amount, and therefore still owed Hyland only the difference between the sum received and the total cost of the materials, $2,050.38.[8]

The existence of the duty to apply funds to a secured debt rather than to other debts is determined by what the majority opinion in the reported case called the "federal equity rule." Both the majority and the dissent used this rule but differed as to its nature and application, and thus reached different conclusions. The following cases demonstrate the nature and the application of this rule.

It is to be noted that the courts apply this basic rule in cases which involve two different fact patterns: where there is surety-principal-supplier; where there is surety-principal-subcontrator-supplier. In the first situation it is generally the principal who wrongs the surety by misapplying or directing the supplier to misapply the funds from the secured job. In such a case it is the surety who is wronged and thus the courts apply the rule in behalf of the surety alone. If the supplier misapplies the funds on his own initiative, the rule will also be extended for the relief of the principal. In the second situation it is usually the subcontractor or supplier or both who misapply the funds from the secured job to other unconnected and unsecured debts. Thus, since both the principal and surety are wronged, the rule will be applied on behalf of both.[9]

The first federal case to expound the federal equity rule is *Columbia Digger Co. v. Sparks*.[10] The Court of Appeals for the Ninth Circuit held that a surety is not bound by the supplier's application of payments from the secured job to an old account rather than to the secured account—even though the supplier had no knowledge as to the source of the money. The dissent stated that "the decision of the majority exhibits a tender regard for the rights of sureties, but a woeful disregard for the obligation of private contracts."[11] As the result of the court's strong desire to protect sureties from unjust payment, to the complete disregard of the supplier's interest as a creditor, the court limited the supplier's freedom of application of pay-

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7 Id. at 139.

8 Id.

9 This is not extraordinary when the relationship of surety and principal is examined. The principal is primary obligor on the bond while the surety is only secondarily liable. Only when the principal is unable to satisfy claims under the bond, is the surety required to make the payments. Thus in the cases where the supplier attempts to misapply funds to an unsecured debt, the federal equity rule will be seen to protect the principal as well as the surety, since as regards the supplier, the liability of the principal and the surety is the same.

10 227 F. 780 (9th Cir. 1915).

11 Id. at 786.

ments without requiring that he at least know where the payment came from. The decision consequently put the burden on the supplier to inquire where the money came from—a business impertinence at best. The court's approach in this case is seen to be one-sided in favor of the surety when compared with the position taken in later federal cases.

In 1933, the Fourth Circuit decided *United States ex rel. Crane Co. v. Johnson, Smathers & Rollins*.[12] The court held that the surety on a bond is entitled to have the payment applied to the secured debt if the supplier *knows the source* of the funds, when the payment is made "with the identical money for the payment of which the surety is bound, or with the proceeds or fruits of the very contract . . . covered by the obligation of the surety . . . ."[13] Here the supplier knew the funds were the proceeds from the prime contract. If the supplier does not apply the payment to the secured debt he loses his right on the bond to recover from the surety or principal or both. This is the consequence even if the supplier has been directed to apply the payments to the unsecured debt by the principal or subcontractor.The loss of rights under the bond is total if neither the surety nor the principal is responsible for the misapplication. Unlike the court in *Columbia Digger Co. v. Sparks*, the court in *Johnson* expressed a measure of concern for the supplier. "[I]t places no burden or hardship upon a creditor who has knowledge of the source of the money to require him to apply the payment to the guaranteed debt . . . ."[14]

This requirement of knowledge of the source was reiterated in *R. P. Farnsworth & Co. v. Electrical Supply Co.*[15] which involved the fact pattern of surety-principal-subcontractor-supplier. The subcontractor had directed, by agreement with the supplier, that the funds be applied to his older debts owed to the supplier, rather than to the debt secured by the bond. This agreement was presumably the result of the supplier's realization of the subcontractor's shaky financial condition. The court expressed its desire to protect the principal as well as the surety from injustice and prejudice. Such would be the result if the supplier were allowed to apply the funds to the subcontractor's unsecured debts, with knowledge of the source of the payments and of the fact that the subcontractor was financially insecure and a bad credit risk, and then look to the principal and surety for payment for the materials supplied on the secured account.[16]

The *Farnsworth* court, for apparently the first time in the federal cases, then stated the theoretical basis of the federal equity rule and its imposition of the duty to apply funds to secured rather than unsecured debts. As the first step in the analysis of the source of the supplier's duty, the court stated that the principal owed a duty to the surety not to divert funds from the secured job—a duty that will be recognized in equity.[17] The court then

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12 67 F.2d 121 (4th Cir. 1933).

13 Id. at 123.

14 Id. at 123-24.

15 112 F.2d 150 (5th Cir.), rehearing denied, 113 F.2d 111, cert. denied, 311 U.S. 700 (1940).

16 112 F.2d at 153.

17 Id. See Town of River Junction v. Maryland Cas. Co., 110 F.2d 278 (5th Cir. 1940).

went on to say that a subcontractor owes a similar duty to both principal and surety as a derivation from the principal's duty to the surety.[18] This deduction is logical not only since the subcontract is subordinate to and contingent on the prime contract, but also since the principal will be unable to perform his duty if the subcontractor is allowed to divert the funds from the secured job and apply them to other unsecured debts. This same reasoning was applied so as to extend the duty through the subcontractor to the supplier.

A fact situation similar to that in *Farnsworth* was before the court in *United States ex rel. Carroll v. Beck*.[19] The court held that the surety and principal would be prejudiced if they were not discharged from the bond obligation, and did discharge them on the basis of the federal cases discussed above. For apparently the first time in the federal cases, however, the court referred to Section 388 of the Restatement of Contracts.[20] This section states the exception to the general rule that the debtor and creditor are free to apply payments any way they see fit. The creditor (supplier) must know not merely the identity of the source of the funds, but must know about the source so that he knows or has reason to know that the payor (principal or subcontractor) has a *duty* to a third person to discharge a particular debt.[21] The supplier must know that the payor is under an obligation to apply certain funds to the particular debt rather than knowing merely where the money came from, e.g., *X* may know that *A* is paying him with money received from *B* (identity of the source) but not know that *A* is duty-bound to *B* to apply the money to a particular debt of *A* held by *X* (about the source). Although the court professes to decide the case on the basis of federal case precedent, it demonstrates that the particular facts of the case meet the standards of the Restatement.[22] The court's rationale is confusing, as the court seems to be offering either federal case precedent or the Restatement as the basis of its decision, although apparently not to their mutual exclusion.

The Tenth Circuit was confronted with this confusion when it decided the 1962 case of *Koehring Co. v. United States ex rel. Hoover Equip. Co.*[23] The court cited and applied the Restatement formulation as the basis of its decision. Though the court cited both *United States ex rel. Carroll v. Beck* and other federal cases, it clearly and unequivocally espoused the Restatement formulation. The court said that "knowledge or notice of the debtor's *duty* is essential to the application of the special rule. . . ."[24] (Emphasis added.) In this case the supplier knew the source of the funds but did not know that the source was the prime contractor on a government contract. The court clearly noted the difference between knowing the identity of the source and knowing about the source and found for the supplier since he did

18 112 F.2d at 153.
19 151 F.2d 964 (6th Cir. 1945).
20 Id. at 966.
21 Restatement of Contracts § 388 (1932).
22 151 F.2d at 966-67.
23 303 F.2d 468 (10th Cir. 1962).
24 Id. at 470.

not know that the payor (subcontractor) was under duty to the source (prime contractor) to discharge the particular debt.[25] Thus, knowledge of the source, instead of being the determinative factor, took on the character of *evidence* that the supplier knows of the debtor's *duty*.

The court in *St. Paul Fire & Marine Ins. Co. v. United States*,[26] in applying the Restatement rule, analyzed the cases of *Johnson*, *Farnsworth* and *Beck* and demonstrated that there were many other factors besides the mere notice of the source of the funds which influenced those decisions. For example, the supplier had access to the subcontractor's books, the supplier knew that the source of the funds was a government job, the supplier knew of the subcontractor's shaky financial condition, the supplier and the subcontractor were closely related or had a history of business dealings. All these factors possess a probative value tending to establish that the supplier knew or should have known of the debtor's duty.[27] Thus the espousal of the Restatement formulation is not a drastic change in the formulation of the federal equity rule. The rule now merely requires such knowledge *about* the source so that the supplier knows or has reason to know of the payor's duty to a third person to discharge a particular debt.

The majority opinion in *Franchi* cited most of the above federal cases but fell short in analyzing them. The court distilled from the cases only the earlier and incomplete concept of the federal equity rule where mere knowledge of the *identity of the source* sufficed to require the supplier to apply the payments to the secured account. The court expressed only the skeleton of the federal equity rule rather than the full-bodied rule as set forth in the previous discussion. Indeed, nowhere in the decision is there a definite and concrete statement of any formulation of the rule—even the older rule based on knowledge of the identity of the source.

The dissenting opinion[28] correctly took cognizance of Section 388 of the Restatement and recognized it as the basic formulation of the federal equity rule. The dissent misapplied the rule, however, by viewing Franchi's notice of Hyland's payment misapplication as preventing the duty from ever arising. The dissent's position appears to stem from a faulty premise—a presumption that Hyland neither knew nor had reason to know of Fairway's duty, because Franchi failed to reply to Hyland when informed of Hyland's allocation of the funds.[29] This presumption is erroneous. Hyland knew that Franchi was the source of the funds and was the prime contractor on a government contract. This fact alone is sufficient to charge Hyland with knowledge of Fairway's duty to Franchi and Maryland.[30] Moreover, analysis

[25] Id.

[26] 309 F.2d 22 (8th Cir. 1962).

[27] In *St. Paul* it is the closeness of the relationship between the subcontractor and the supplier which created the equity in favor of the surety. In other words, it proved that the supplier knew of the subcontractor's specific duty owed to the principal and surety on the bond required by the Miller Act. Id. at 30.

[28] 378 F.2d at 139.

[29] Id. at 141. The dissent concurred in the majority's decision as to the surety, Maryland, i.e., that it could not be adversely affected by Franchi's failure to reply when notified of the allocation of the funds by Hyland.

[30] See Houston Fire & Cas. Ins. Co. v. E.E. Cloer Gen. Contractor Inc., 217 F.2d

of the federal cases and especially Restatement section 388 reveals no mention of the effect of such notice on the actual accrual of the duty. Thus, it would seem that such notice would be more properly treated as a possible defense to the breach of the duty, along the lines of an equitable estoppel. In fact, the counsel for Hyland recognized the propriety of this approach and placed a heavy reliance on the defense of equitable estoppel.[31]

Although the majority's analysis of the federal equity rule is incomplete, its decision is nevertheless the correct one if examined in the light of the federal equity rule as formulated in the federal cases and Restatement. Franchi was under a duty to its surety, Maryland, not to divert funds from the secured job.[32] As the logical extension of this duty and because Fairway's subcontract is subject to the prime contract and its bond, Fairway was under a duty to both Franchi and Maryland to apply the proceeds from the secured job to the secured materials account.[33]

The facts easily demonstrate that Hyland had actual knowledge of Fairway's duty to Franchi and Maryland.[34] By way of evidence, Hyland knew the source of the payments—Hyland had itself requested Franchi to issue checks payable to Fairway *and* Hyland. Hyland had notified Franchi as to the amount with which the Franchi-Fairway account was credited and actually sent copies of its ledger cards to show the amounts credited to the Franchi-Fairway account. Moreover, the heading on Hyland's accounts receivable ledger is an indication that Hyland was well aware that it was involved in a government construction contract.[35] In *Houston Fire & Cas. Ins. Co. v. E. E. Cloer Gen. Contractor, Inc.*,[36] the supplier was held to a knowledge of the bond required by the Miller Act when he knew he was involved in a government contract.[37] The court in the *Koehring* case assumed that if the supplier knew that the source of the payment was a prime contractor on a government job, he would have reason to know of the subcontractor's duty to discharge the particular secured debt.[38]

906, 909 (5th Cir. 1954); United States ex rel. Carroll v. Beck, 151 F.2d 964 (6th Cir. 1945).

> Henry, however, was a subcontractor, and his subcontract was subject to the terms of Beck's [principal] contract with the government. By that contract Beck undertook promptly to pay all claims for labor and materials and to protect the government from liens. Henry knew the extent of Beck's obligation to the United States, and contracted with Beck in subordination to it. Carroll [supplier] must likewise be charged with knowledge of the obligations of both.

Id. at 967. See also Koehring Co. v. United States ex rel. Hoover Equip. Co., 303 F.2d 468, 469 (10th Cir. 1962).

31 Brief for Appellee at 9-10, 378 F.2d 134 (2d Cir. 1967).

32 See p. 505 & note 17 supra.

33 See cases cited note 30 supra.

34 378 F.2d at 135-36.

35 The accounts receivable ledger bore the heading,

Ammunition Storage Facility
Air National Guard
Burlington, Vermont.

Brief, supra note 31, at 3a-4a (Appendix).

36 217 F.2d 906 (5th Cir. 1954).

37 Id. at 909.

38 303 F.2d at 469.

Hyland knew not only the source but also knew that the source was the prime contractor on a government job. Thus, it was chargeable with the knowledge of the subcontractor's duty and acquired the duty imposed by federal law to apply Franchi's payments coming from Fairway to the secured account regardless of any directions or arrangements with Fairway to the contrary.[39]

Franchi's silence in response to Hyland's admission of breach of duty is, at best, available to Hyland as a defense in the nature of equitable estoppel. The federal rule imposes the duty without reference to the effect of such notice. As the majority pointed out, however, such a defense is not available to one unless he has relied to his detriment on the conduct of the other party.[40] Hyland has made no such claim or showing of detrimental reliance. In fact, even if Hyland did so rely, such reliance would probably be unjustifiable.[41] Thus, the facts of the reported case clearly meet the requirements of the federal equity rule set forth in Section 388 of the Restatement. Hyland was under an equitable obligation to apply the funds it received to the secured Franchi-Fairway account.

The federal equity rule as set forth in section 388 appears to be a logical and pragmatically desirable rule. The rule merely requires that the supplier act fairly and justly in accordance with his knowledge of certain facts such as the payor's shaky finances, the source of the funds, a government contract, etc. It is also quite ordinary, as in the reported case, for the supplier to carry a separate account for the secured debt. Thus, with such knowledge, a supplier has no cause to complain, for there is no commercial burden in requiring him to credit the secured account with the funds from the secured job. Indeed, if there is any slight burden, it is on the principal and surety to make certain that the supplier has the requisite knowledge.[42] As seen in *Farnsworth*, this duty on the supplier is the logical extension of the subcontractor's duty owed to the principal and surety.[43]

A further reason for imposing such a duty on the supplier is the very relationship that exists between the supplier and the principal and his surety. The supplier is the one who has, on prior occasions, extended credit to the financially shaky debtor without requirement of security. In spite of outstanding debts, the supplier again furnishes to the subcontractor on credit, materials to be used on the government job. This latter extension of credit, however, is in effect secured by the principal and surety by reason of the bond. The supplier, in all practicality, receives the same benefits as a principal and, as previously stated, a principal cannot divert funds from the secured job.[44] Also, it is reasonable to state that the surety on the bond intends to take only the risks he is paid to take and not risks attendant to other unrelated business ventures. Thus it is, indeed, less than equitable to

39 The Restatement section 388 imposes this duty "in spite of the fact that the payor directs that the payment shall be applied to the discharge of another debt."

40 See p. 503 & notes 4 & 5 supra.

41 See Restatement of Contracts § 387, Illustration 1 of Clause (a).

42 See 83 U. Pa. L. Rev. 898, 905 (1935).

43 See p. 504 supra.

44 See p. 505 & note 17 supra.

allow the supplier to "cover" debts which, for all practical purposes, are uncollectible, and then sit back secure in the knowledge that he can sue on the surety bond to recover for the materials furnished on the secured account.

The cases here under discussion, though issuing from different circuits, evidence a definite unity in refinement of approach. The federal equity rule concerning the application of payment can be seen as having experienced an evolutionary development culminating in an alignment with the formulation found in Section 388 of the Restatement of Contracts. It is unfortunate that the reported case, as the most recent pronouncement on the subject, failed to crystallize a more intelligible and firm guideline by which the business world can function. It seems correct to state, however, that the federal courts, in adjudicating future cases involving issues similar to those in the reported case will be using the federal equity rule as formulated in Section 388 of the Restatement of Contracts.

LEO B. LIND

Securities Regulation—Section 10(b)—Requirement of Sale—Long Form and Short Form Mergers Are Sales.—*Dasho v. Susquehanna Corp.*;[1] *Vine v. Beneficial Fin. Co.*[2]—In *Dasho*, Korholz, a director and major stockholder of American Gypsum Company, arranged with the directors of The Susquehanna Corporation to purchase their Susquehanna stock at a price in excess of market value. Korholz purchased the Susquehanna stock, then sold it to Gypsum. Fulfilling their obligations to Korholz under the purchase agreement, the Susquehanna directors passed control of Susquehanna to Korholz through seriatim resignation of the incumbents and election of Korholz as chairman and his nominees as directors. Using his position as chairman of both corporations, Korholz obtained approval for a Susquehanna-Gypsum merger from the respective boards of directors. Before the proposed merger was submitted to the stockholders for their approval, Dasho and other Susquehanna stockholders brought a stockholder derivative suit against the new officers and directors of Susquehanna in the federal district court seeking injunctive relief and damages. Plaintiffs alleged that the defendants had conspired to defraud the corporation in violation of Section 17(a) of the Securities Act of 1933,[3] Section 10(b) of the Securities Exchange Act of 1934,[4] and Rule 10b-5[5] since their activities would cause Susquehanna to

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1 380 F.2d 262 (7th Cir.), cert. denied, 88 S. Ct. 480 (1967).

2 374 F.2d 627 (2d Cir.), cert. denied, 88 S. Ct. 463 (1967).

3 15 U.S.C. § 77q (1964) provides in pertinent part: "(a) It shall be unlawful for any person in the offer or sale of any securities . . . (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

4 15 U.S.C. § 78j (1964) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any